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The President's Social Security Proposals and Revenue Options for Solving the Problem

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Mr. Chairman and members of the committee, thank you for the opportunity to testify. I was asked to comment on the President's Social Security proposals, including the proposal to invest trust fund balances in the stock market, and to comment on revenue implications of other Social Security reform options.

The President's Proposals

It is best to think of the President's program consisting of five unrelated components. They are:

1. Create debt and deposit it in the trust funds.
2. Save almost three-quarters of projected unified budget surpluses.
3. Invest some trust fund balances in equity markets.
4. Create Universal Saving Accounts,

Work for a bipartisan agreement on further reforms.

Create Debt and Deposit It in the Trust Fund - The President's Social Security proposal does not change benefits or payroll taxes. Consequently, it does nothing to mitigate the increased economic burden imposed by the system after 2010 when the baby boomers are retiring, life expectancy continues to grow, and labor force growth virtually ceases because of massive retirements and a low number of youthful entrants.

Adding debt to the trust fund does not make it any easier to pay future benefits. When the trust fund experiences a deficit, the debt will be presented to the Treasury and it will be redeemed either by raising taxes, cutting spending, borrowing from the public, or creating new money. Those are the only possibilities. Exactly the same options would have to be considered to finance a Social Security deficit if there were no assets in the trust fund.

The President links his desire to add debt to the trust fund to his goal of saving the projected unified budget surplus. But it is important to understand that the new debt is created with the stroke of a pen and that this accounting maneuver could be accomplished even if we were running a unified deficit. Conversely, the surplus could be saved without adding any debt to the trust fund. The President chooses to equate the amount of debt created to 62 percent of the projected unified surplus, but he could, as easily, equated it to 62 percent of the average temperature in March.

The President's gesture may not have important direct economic effects, but it represents an important philosophical change in the nature of Social Security . It has been assumed traditionally that benefits would be almost entirely financed by the payroll tax. The President's proposal eliminates this discipline by suggesting that the trust fund can receive an infusion of assets from the rest of government any time it gets into financial trouble. As a practical matter, this makes it much more likely that Social Security benefits will be financed by something other than payroll taxes in the future -- other tax increases, spending cuts, or borrowing. The program will become more like welfare and less like social insurance.

Save About 75 Percent of the Projected Surplus - If we do not have the win to change Social Security benefits or taxes, saving the surplus represents a second best approach to reducing future Social Security and Medicare burdens. It will reduce future interest costs to the government, thus making it easier to afford the benefits defined by current law. Saving the surplus will also enhance future economic growth. Because initial Social Security benefits are indexed to growth, increased growth has the effect of raising real per capita benefits. Consequently, increased growth does not greatly reduce the burden of Social Security relative to income. However, more growth does help a bit, because once the initial level is set upon retirement, benefits are held constant in real terms.

The relationship between growth and Medicare has not been studied as intensely. Growth will increase the wages of medical personnel and so raise Medicare costs, but nevertheless, I would speculate that the cost growth would rise less than the growth in total incomes.

Although saving the surplus is beneficial, it is not sufficient to solve the problem. CBO estimates that the surplus would have to be increased immediately by 0.6 percent of the GDP to avoid a long-term debt explosion. Instead of increasing the surplus, the President's proposal reduces it by about 25 percent in order to finance spending increases and individual accounts. That is to say, the surplus will be reduced by roughly 0.5 percent of the GDP over the next few years rather than being increased by 0.6 percent. Consequently, further spending cuts or tax increases will be necessary in the future and the longer we wait, the larger they will have to be.

My preferred approach is to use the surplus to finance the transition to a system of individual accounts. The individual accounts must be designed to make up for a slowdown in the growth of Social Security benefits. This is the approach taken by the National Commission on Retirement Policy (NCRP), co-chaired by Senator Breaux, and on which, I was a member. The basic strategy is to accept some worsening of the fiscal situation in the short run in order to buy a major improvement in the long run.

Invest Some Trust Fund Balances in Equity Markets - Historically, the Social Security trust fund has invested only in government bonds. President Clinton would like it also to invest in corporate stocks. The stocks are expected to yield a higher return than bonds, thus postponing the date at which the trust fund is exhausted by the retirement of the baby boomers. According to his plan, the trust fund would own about four percent of the stock market within fifteen years. Because the stocks are purchased by issuing additional bonds to the public, the government is, in essence, buying the stock on 100 percent margin.

It is a bad idea. The potential gain is less than is claimed and the risk is high t the Congress would use the equity investments of the trust funds for political purposes.

Proponents of equity investment say that investment managers could be given political independence by creating a structure similar to that of the independent Federal Reserve Board. But this misses the point. It is not the managers that one worries about. It is the Congress. Independence can be destroyed by passing one law. That has happened in states like Texas and California where legislatures have politically interfered in the decisions of state employee pension funds.

Proponents reply that the Congress has not interfered in the conduct of monetary policy. However, it is not the structure of the Federal Reserve that protects it. If the Congress irresponsibly interferes with monetary policy, stock and bond markets will crash. It is this fear that keeps the Fed relatively free of

Congressional meddling. In contrast, if Congress wanted to use the trust funds to punish certain corporations, the market would be its ally. If the Congress decreed that the trust funds should no longer buy tobacco stocks, it would do so hoping that tobacco share prices would fall.

Proponents also use the civil service employees' thrift plan as an example of government management of equity investments that is free from political interference. But the thrift plan is fundamentally different from Social Security. Civil servants own the accounts and their pensions depend directly on how much their investments earn. If the Congress interfered with the investments, civil servants would be justified in raising an enormous fuss.

Social Security benefits are determined by a formula that has no connection to the rate of return on trust fund investments. If Congress interfered in trust-fund stock investments, few people would be affected directly. There would be very little protest. If trust funds earn less than expected because of political interference or because the market performs less well than expected, the Congress can wait decades before cutting benefits or raising payroll taxes.

In fact, if the President's whole Social Security proposal is adopted, the Congress will never have to act to change the structure of the system in response to disappointing returns on stock market investments. Under his plan, the Social Security system is given a huge subsidy from the rest of government. That subsidy can be increased if the trust funds investments are interfered with or perform poorly. As noted above, the President's plan destroys the long-standing tradition that Social Security benefits should be almost entirely financed by payroll taxes.

Not only are the risks high, but the gain from stock market investments is often exaggerated. The government's entry into the stock market will drive up the price of stocks. The fact that the trust fund is buying fewer bonds will mean that more bonds must be sold to the public. This, in turn, will raise interest rates. That could be very costly for the government. As it refinances the public debt, every one-hundredths of a point increase in the interest rate costs about $300 million per year in the long run.

In addition, if the income of the trust fund is increased by these transactions, the income of the public must go down. As income is moved from the private to the public sector, it is no longer taxed and the loss in tax revenue could be significant. These indirect costs are seldom mentioned when the President's proposal is discussed.

If it is a good idea to invest Social Security money in the stock market, it should be a good idea for the highway trust fund as well. Indeed, the Pentagon can probably figure out ways to buy aircraft carriers out of stock market profits. If a little bit of socialism is a good idea, a lot should be wonderful. But the world has had some experience with that idea. I hope that we have learned something.

Create Universal Saving Accounts - It is difficult to comment on this proposal, because few details have been released on how the accounts would be structured, taxed, and administered. Generally, I favor measures to enhance saving. As a matter of tax policy, I would like to see current restrictions on IRA's, 401k's, etc. relaxed.

However, if accounts are created within a package related to Social Security reform, the main intent is usually that they should replace rather than supplement benefits. That is to say, they should be traded for a slowdown in benefit growth. The individual accounts should be structured with the goal that the returns on the accounts will approximately make up for lost benefits. If accounts are created specifically to supplement benefits, it would be better to consider them within the context of existing tax favored accounts, so that we do not end up with yet another type of retirement account with its own set of rules. We have enough already.

Work for a Bipartisan Agreement on Further Reforms - We do not know what the President has in mind. The only description of these reforms is that they should extend the life of the trust fund from 2055 to 2075. This goal could be satisfied by just throwing more debt into the trust fund. It is to be hoped that more substantive changes are intended.

An ideal reform would adjust benefits and or taxes, so that the present value of taxes and benefits are equated in perpetuity. If the system is "fixed" only until 2075, the trustees' 75-year projections one year later will indicate that the system is again in deficit.

Revenue Options

The Social Security problem should be resolved entirely by slowing the growth of benefits rather than by increasing payroll taxes or subsidizing the system with general revenues. As difficult as it will be to solve the Social Security problem, it will be much harder to deal with the problems of Medicare and Medicaid. Consequently, the possibility of a tax increase should be preserved to deal with health programs.

Medicare and Medicaid problems are much larger quantitatively than those of Social Security. The CBO projects that Social Security's share of the GDP will rise 2 percentage points between now and 2050, while Medicare and Medicaid's share will rise by 6 percentage points, assuming that GDP growth is not affected by the large increases in the economic burden imposed by entitlements.

Moreover, much of projected increase in the burden associated with Social Security stems from the fact that each successive cohort of retirees is promised increased real per capita benefits because of the way that the benefit formula is indexed to wages, Simply holding the absolute standard of living of the retired population constant would come close to solving the entire Social Security problem. It should not be as hard as it seems to be. Medicare and Medicaid also provide rising real per capita benefits, because health costs are rising faster than other prices in the economy. But holding real per capita costs constant in the long run will involve rationing benefits, perhaps depriving individuals of new medical technology. This will be extremely difficult emotionally, and therefore, politically.

If it is, nevertheless, decided to solve part of the Social Security problem by raising taxes, there are numerous possibilities since the President has opened the door wide to general revenue financing. Any tax could be increased or a new tax could be invented. I shall, however, confine my remarks to tax issues traditionally related to Social Security.

Payroll tax options - Almost one-half of the actuarial deficit of Social Security could be resolved by raising the tax rate on employers and employees by 0.5 percentage points. Approximately the same revenues could be obtained if the payroll tax base were a bit more than doubled.

Raising the tax rate is obviously less progressive than raising the tax base. However, a relatively small share of the tax increase would be paid by low income taxpayers. When taxpayers have low income, it is often because they are not employed or retired, and therefore, do not pay payroll taxes. If the tax rate had been raised by 0.5 percentage points on both employees and employers in 1995 when the payroll tax base was $61,200, about 3 percent of the tax increase would have been paid by those with adjusted gross incomes less than $10,000. For those with incomes under $5,000, the average tax increase would be less than 50 cents a week. However, this represents a large percentage increase in the payroll plus income tax, because many in this class pay little or no income tax and their income tax burden can be negative because of the earned income tax credit. If it were deemed desirable to reduce the burden of the payroll tax rate increase on low earners, that could be accomplished by increasing the rate of the earned income credit.

About one-quarter of the increase would be paid by tax payers with adjusted gross incomes between $50,000 and $75,000. Another quarter would be paid by those between $75,000 and $200,000. It should be noted that the payroll tax is not significantly regressive until far above the payroll tax base, because tax paying units often achieve high incomes only because both husbands and wives are working. For such couples, earnings up to $122,400 could have been subjected to the tax increase in 1995. For those above $200,000, the percentage increase in total payroll plus income taxes is a trivial 0.7 percent compared to an average for all taxpayers of about 3 percent.

Raising the payroll tax base to $135,000 in 1995 would have raised the same revenues as the previously described rate increase and would not have affected any earning less than $61,200. Its impact would be concentrated on those with AGIs between $100,000 and $200,000. Assuming no behavioral response, they would have paid about one-half the tax increase.

However, it is likely that a large increase in marginal tax rates on those earning between $61,200 and $135,000 would have provoked a significant behavioral response. A single, self-employed individual earning $75,000 would see his or her marginal rate go from about 33 percent (includes personal income and HI marginal rates) to about 43 percent, not counting any state and local income tax. That might be sufficient to induce a sole proprietorship or partnership to incorporate, so that some earnings could be redefined to be profits or dividends not subject to the payroll tax. A higher rate also makes other types of tax avoidance more likely and is likely to increase tax evasion. There may also be negative effects on work effort and savings. For example, a person may be induced to retire earlier than would happen otherwise.

Increasing the payroll tax rate does not increase the future entitlement to benefits. Increasing the base would increase future benefits under current rules. However, the replacement rate at higher credited lifetime incomes is so low that the system would still earn a significant long-run "profit" from a base increase. But base increases and rate increases raising the same revenues immediately will have different effects on the actuarial balance in the system. To have the same effect on actuarial balance, the base would have to be increased to something greater than $135,000.

The choice between rate increases and base increases faces the usual trade-off between equity and economic efficiency. Base increases concentrate the pain on the more affluent, but are likely to have negative impacts on tax administration, work effort and saving. Obviously, it is possible to react to this trade-off by considering various mixtures of rate and base increases.

In examining the distributional characteristics of payroll tax increases, it is important not to think of them in isolation. If the Congress wishes to reform the system, alternative options will also have distributional effects and they should be compared to those resulting from payroll tax options. If there are no changes in law, the current benefit structure cannot be sustained. When the trust fund runs out of financial resources, it is not allowed to pay more in benefits than can be financed by incoming payroll tax receipts. However, the law is not clear on how benefits should be cut under those circumstances. Perhaps, equal proportional cuts should be assumed, and the distributional effect of various reform options should be compared to that baseline.

Increasing the Taxation of Benefits - Currently, the taxation of Social Security benefits is extremely complicated. The taxpayer must adjust income by adding one-half of Social Security benefits plus tax free interest to adjusted gross income. Fifty cents of Social Security benefits must be added to taxable income for every dollar that the adjusted income exceeds $25,000 for singles and $32,000 for joint returns. Eighty-five cents benefits must be added to taxable income for every dollar of adjusted income in excess of $34,000 for singles and $44,000 for joint returns.

Aside from being complicated, the phase-in of the taxation of benefits has the effect of significantly increasing the implicit marginal rate paid on extra work and saving, To the extent that the phase-in overlaps with the earnings test that reduces benefits one dollar for every three dollars earned, the work disincentive can be substantial.

The Congress obviously chose this complicated approach, because it wanted to exempt the benefits of less affluent retirees from being taxed. But this seems unfair, because private pension benefits are typically taxed if recipients have any taxable income at all. Why tax someone with $10,000 in Social Security benefits and a $5,000 private pension differently from someone with $5,000 in Social Security benefits and a $10 000 private pension? This leads many to suggest that Social Security benefits should be taxed "the same as private pensions." This is interpreted to mean that 85 percent of the benefit should be included in taxable income. The other 15 percent is an estimate of the contribution of principal out of after-tax income.

If this was done, it would eliminate about 16 percent of the current actuarial deficit in the system. The distribution tables would not look good, because the burden would fall entirely on the less affluent. But it can be argued that it was unfair to exempt the taxation of their benefits in the first place.

However, all this is predicated on the proposition that it is right to tax 85 percent of benefits. It once was the treatment afforded typical private pensions, but that time is long past. Current tax law recognizes a bewildering array of retirement vehicles that are now afforded special tax treatment. In traditional Mks and 40lks, deposits up to different limits are deductible, but the entire amount is taxable when funds are withdrawn from the accounts. In the relatively new Roth ERA, deposits into the accounts are not deductible, but withdrawals are not taxed.

If the same theory were applied to Social Security, benefits financed by tax deductible payroll taxes (the employer share) would be fully taxed while benefits financed by non-deductible payroll taxes would be tax free. That is to say, one-half of benefits would be included in everyone's adjusted gross income. I do not have an estimate as to whether revenues would go up or down under this approach, but it is unlikely that they would change significantly in either direction as the taxes of the most affluent would be cut a bit whereas those of the less affluent would be raised. If the distributional effects of this approach seem unappealing, the less affluent can be given relief by raising the extra exemption given people over 65. On the other hand, some would question the tax relief already given seniors compared to that given younger people.

Other Proposals - Although much of this testimony has been about increasing taxes, a number of reform proposals would cut the tax burden. The Gregg-Breaux-Kolbe-Stenholm proposal would cut the payroll tax by two percentage points in order to ease the transition to a system of individual accounts. Senator Gramm would cut the payroll tax three percentage points, but compensate the trust funds out of general revenues. Senators Moynihan and Kerrey would also cut the payroll tax, but because they think that it would be more honest to put Social Security on a true pay-as-you-go basis. They would raise the tax in the future as needed. All these plans have provisions that reduce benefit growth. As noted previously, plans that use some of the surplus in this manner in the short-run are worthwhile if they result in a better fiscal situation in the long run. There is always the danger that the first part of the deal is accepted, and the second part is abandoned once it becomes painful. This danger is lessened if the painful part of the deal is clearly defined and well understood before the reform is implemented.

Conclusions

The President's plan to add debt to the trust fund is unfortunate. It does nothing to reduce the real burden of paying future Social Security benefits, but it probably reduces the prospects for true reform by creating the illusion that something real has been done. The proposal to invest some of the trust fund in the stock market is equally undesirable. It creates a large risk of political interference in the market place and the financial gain to the trust fund is offset by a higher interest bill and lower tax revenues in the rest of government.

I do not favor using tax increases to solve the Social Security problem. Medicare and Medicaid problems are larger quantitatively and more difficult to solve. I would preserve any capacity to raise taxes -- and it is small under the best of conditions -- to deal with that more difficult problem.

If payroll taxes are to be raised, both tax base and tax rate increases can be considered. A very large base increase is necessary to raise the same amount of revenue as a relatively small rate increase. To the extent the base is increased, the pain is. concentrated on more affluent taxpayers, but the significant increase in the marginal tax rate facing the upper middle class is likely to reduce economic efficiency and create problems for tax administration. A rate increase pains everyone with earnings including those at the bottom of the income scale. This effect can, however, be mitigated by increasing the earned income credit.

Taxing benefits more heavily can at best solve only a small part of the Social Security problem. The argument for taxing benefits more heavily was stronger before the tax system began to favor various types of private retirement accounts. If Social Security were treated the way that traditional and Roth IRAs are treated, one-half of benefits would be included in AGI.